

March 11, 2011

The Multistate Tax Commission Takes Action on Proposal to Tax Pass-Through Entities Owned by Affiliates Not Subject to Corporate Income Tax

On March 10, 2011, the Executive Committee of the Multistate Tax Commission (MTC) voted to submit to public hearings the model statute that would subject to corporate income tax a pass-through entity owned by an entity that is not subject to corporate income tax (Model Statute). The Model Statute could result in a tax increase for insurance companies and others not subject to an adopting state's corporate income tax.

Background

As reported in Sutherland's *SALT Shaker* (February 18, 2011), the Model Statute, previously approved by the MTC's Uniformity Committee, provides for a partnership or disregarded entity to be taxed by a state, as if it was a corporation subject to tax in that state, if 50% or more of the capital interests or profits interest in the pass-through entity is owned, directly or indirectly, by an entity that is not subject to that state's corporate income tax. If the Model Statute applies, only the net income that passes through to the income tax-exempt entity would be subject to tax. The Model Statute also provides that a real estate investment trust (REIT) is included within the phrase "partnership or disregarded entity."

Executive Committee Action

Prior to taking its vote, the Executive Committee heard a summary of the history and content of the Model Statute from MTC Counsel Sheldon Laskin. Among other comments, Mr. Laskin discussed tax equity concerns expressed by members of the Uniformity Committee when comparing a pass-through entity owned by an entity that is not subject to a state's corporate income tax (e.g., an insurance company) with a pass-through entity owned by an entity that is subject to a state's corporate income tax.

The insurance industry representative, speaking on behalf of various trade associations, requested that the Executive Committee terminate this project. Alternatively, if termination is not an acceptable option, industry requested that, before the Model Statute is submitted to public hearings, the Executive Committee either send the Model Statute back to the Uniformity Committee for further study or establish a public participation working group. One concern raised by industry is the potential for harmful retaliatory tax consequences if the Model Statute is enacted. In addition, the industry argued that there is no tax equity issue here in that studies have shown that premium-based taxes result in the insurance industry having a higher effective state tax rate than the effective state tax rate imposed on other industries under a corporate income tax.

Notwithstanding the efforts of industry, the Executive Committee passed the motion to adopt the recommendation of the Uniformity Committee and directed that public hearings be held on the Model Statute.

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Sutherland Observation: While most states subject insurance companies to state premium taxes (and not to state corporate income taxes) there are some states that do subject insurance companies to corporate income tax. In those states, the Model Statute fails to address the interplay between the “corporate” income taxation of the pass-through entity and the corporate income taxation of the insurance company on the same income. In addition, the Model Statute does not address retaliatory tax issues that may arise in an insurance company’s non-domiciliary states. Finally, while the original target of this MTC project was the insurance industry, the Model Statute allows a state to apply the pass-through entity taxation concept to industries, other than the insurance industry, whose members are not subject to the state’s corporate income tax.

Next Steps

The Model Statute will now become the subject of public hearings. The MTC expressed its desire that members of the insurance industry who participated in the process to date will continue to participate during the public hearing process. The MTC intends to reach out to all who have participated, and to those who it believes should participate (e.g., insurance company regulators), as the public hearing process progresses.



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